(4/30/08)

JOINT COMMITTEE ON SOLUTIONS TO RETIREE HEALTH CARE

Committee Report on Solutions to Retiree Health Care to Board of Administration of the Police and Fire Department Retirement Plan and Board of Administration of the Federated City Employees Retirement System

DATED: **April 30, 2008**
San Jose, California

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MESSAGE FROM SOLUTIONS
COMMITTEE CHAIR MARK SKEEN

During the seven months since October 2007, the Joint Board Committee on Solutions to Retiree Health Care ("Committee") has met to discuss and consider the various issues involved in retiree health care. The Solutions Committee has also reached out to various stakeholder groups to include them in the overall process. At its meetings, the Committee received valuable information from a variety of sources. The information presented to the Committee should be relevant to all stakeholders. The Committee has deliberated carefully to produce recommendations on how best to address future funding and plan design issues with respect to retiree health care.

The Solutions Committee held many open meetings and heard from policy experts, actuaries, representatives of credit rating agencies and from fixed income investment managers, and from Kaiser and Blue Shield representatives.

It became clear to Committee members that health care issues are critical to retirees. It is obvious that, when changes to health care benefits are made after City employees retire, the effect can be very burdensome upon them and can potentially lead to adverse health outcomes to them. Higher costs to both the plan and to plan participants can occur as well. The Committee has concluded that the best way to insure that this does not happen is to prefund these benefits in a reasonable manner.

Prefunding was not the only issue before the Committee. The Committee also heard reports of promising new developments in the health care industry. Through sophisticated use of information technology, care management, and wellness approaches, it appears that the health status of active employees, retirees, and beneficiaries can be improved, progress of disease slowed, all to the benefit of the City of San Jose and its retirees and beneficiaries.

Finally, I would like to thank the members of the Solutions Committee and the City for their work and energy. It is with a common commitment to cooperation and with a shared can-do spirit that we will be able to do what is right for San Jose, its employees, its retirees, and its citizens.

Sincerely,

Mark Skeen, Chair
Joint Board Committee on
Solutions to Retiree Heath Care

(4/30/08)

BOARD SUMMARY: SOLUTIONS COMMITTEE RECOMMENDATIONS TO THE BOARDS

In this report, the Solutions Committee presents recommendations to the Board of Administration of the Police and Fire Department Retirement Plan and the Board of Administration of the Federated City Employees Retirement System concerning the prefunding of retiree health care and concerning plan design issues that could enhance retiree health now and in the future and reduce plan expenses. The following recommendations are divided into ten groups to facilitate Board review and consideration.

A. Solutions Committee Recommendation: *Statement of Guiding Principles*

The Solutions Committee concluded that it was useful to place more specific policy recommendations within a broader conceptual framework. The Committee proposes the following statement of guiding principles:

1. In addressing retiree health care issues, it is important at all stages of the process to engage the various stakeholders, including retirees.

2. In addressing retiree health care issues, it is important to participate in a collaborative process, seeking options and feedback from the various stakeholders.

3. In addressing retiree health care issues, it is important to acknowledge that the cost of retiree health care presents a challenge that we must all work to address.

4. In addressing retiree health care issues, it is important to consider the impact of any course of action upon retirees and to minimize disruption through effective communication.

5. In addressing retiree health care issues, it is important to move to full prefunding of retiree health care in accordance with a reasonable plan and timetable.

6. In addressing retiree health care issues, it is important to seek innovative solutions to health care, rather than simply shifting costs to retirees.

7. In addressing retiree health care issues, it is important to consider adopting programs for active employees and retirees that promote health, thereby decreasing illness and disease and reducing the demand and resulting costs of health care.

8. In addressing retiree health care issues, it is important to consider adopting programs that enable active employees and retirees to better manage chronic diseases that they may have.

9. In addressing retiree health care issues, it is important for the City to adopt health plan choices that offer flexibility and options.

10. Above all, in addressing retiree health care issues, it is important to proceed carefully, to plan thoroughly, and to be thoughtful.

The Committee believes that consideration of such guiding principles will increase the likelihood of achieving outcomes of which we can all be proud.

B. Solutions Committee Recommendation: *Prefunding of Retiree Health Care*

The deliberations by the Solutions Committee have been enhanced by the publication in January 2008 of the report by the Public Employee Post-Employment Benefits Commission ("Commission"). The Commission was established through an executive order issued in December 2006 by Governor Schwarzenegger, was composed of well-respected and knowledgeable individuals appointed either by the Governor or by the legislative leadership, and held a number of meetings throughout the State focusing upon the costs of retiree health care. The Commission issued a substantial, thoughtful report. The Solutions Committee has concluded that several of the Commission's recommendations are applicable to San Jose. The Solutions Committee further concluded that other reasonable steps and approaches should be included as components of an overall funding plan for retiree health care. More specifically:

1. The Boards should recommend to the City the adoption of recommendation no. 1 of the Public Employee Post-Employment Benefits Commission:

   > Public agencies providing OPEB [other post-employment benefits] benefits should adopt prefunding as their policy. As a policy, prefunding OPEB benefits is just as important as prefunding pensions. The ultimate goal of a prefunding policy should be to achieve full funding.

2. The Boards should recommend to the City the adoption of recommendation no. 2 of the Public Employee Post-Employment Benefits Commission:

   > Each public employer shall identify its OPEB liability, adopt a prefunding plan, and make it public. If a public employer does not establish a prefunding plan, it shall clearly identify an alternative approach for addressing its OPEB liabilities and make public its reason for not prefunding.

3. The Boards should recommend to the City the adoption of the following portion of recommendation no. 4 of the Public Employee Post-Employment Benefits Commission:

   > Any employer considering the use of OPEB bonds should fully understand, and make public, the potential risks they bring.

4. The Boards should recommend that the City adopt a written plan setting forth how the City intends to fund retiree health care.

5. The Boards should recommend to the City the adoption of a reasonable ramp-up period, i.e., one not less than five years, to reach full funding of the annual required contribution (ARC) required by Government Accounting Standards Board (GASB) Statement nos. 43 and 45.

6. The Boards should recommend that any prefunding plan be based upon the actuarial assumed interest rate of each plan and an open amortization period of thirty years.

7. The Boards should recommend to the City the early evaluation of prefunding vehicles, including but not limited to, a voluntary employees beneficiary association (VEBA), other types of employee benefit trusts, and CalPERS's prefunding vehicle.

C. Solutions Committee Recommendation: *GASB Monitoring*

Public agencies across the country are presently addressing the implementation of GASB 43 and 45 reporting requirements. The Solutions Committee concluded that monitoring of developments in this area be deemed a priority matter. More specifically:

8. The Boards should direct the systems' actuaries to provide updates on future GASB determinations and requirements related to post retirement benefits.

9. The Boards should direct their external auditor to do likewise.

10. The Boards should direct the systems' actuaries, auditor, legal counsel, and staff to monitor the responses to GASB 43 and 45 reporting requirements by other public agencies.

11. The Boards should comply with the following portion of recommendation no. 28 of the Public Employee Post-Employment Benefits Commission:

> Boards overseeing pension or OPEB trust funds should evaluate not only reported actuarial liabilities and assets but also the underlying assumptions including discount rates, investment returns, mortality, health care inflation, and whether plans are open or closed systems. Boards should understand the sensitivity to changes in these assumptions, as well as the difference between actuarial values and market values….In addition, the trustees of public retirement systems, as well as the trustees of OPEB trusts, should receive continuous training related to the understanding and fulfillment of their fiduciary responsibilities, actuarial methodology and assumptions, and conflict of interest requirements.

D. Solutions Committee Recommendation: *Legal Issues*

12. The Boards should consider convening a special meeting at which all involved parties are invited to attend to consider approaches to health plan design.

13. The Boards should consider convening a special meeting to determine their interpretation of lowest cost medical plan.

E. Solutions Committee Recommendation: *Improved Access to Health Information*

14. The Boards should consider retaining a health consultant to assist the Boards in evaluating innovative approaches, such as those employed by individualized care

management firms, that assist active employees and retirees to be better informed of their health care options.

F. Solutions Committee Recommendation: *Wellness*

The Solutions Committee has concluded that a strong commitment to implementing wellness programs offers a realistic likelihood of enhancing the health of active employees and retirees, while at the same time reducing the demand for health care.

15. The Boards should consider retaining a health care consultant to assist the Boards in evaluating wellness programs.

16. The Boards should consider directing the health care consultant to review the wellness literature and report relevant developments to the Boards on a regular basis.

17. The Boards should consider having the health care consultant evaluate some or all of the following:

    - Current wellness programs of the City's health plan providers;
    - Wellness programs for active employees and dependents in conjunction with or in addition to the City's current health plan providers;
    - Wellness programs for retirees and beneficiaries in conjunction with or in addition to the City's current health plan providers;
    - Periodic health fairs for actives and retirees;
    - Use of incentives as components of a wellness program;
    - Wellness communications to actives and retirees; and
    - Discounts on gym memberships, diet programs, non-smoking programs, etc. (combined with legal analysis of liability and the role of waivers/release of claims).

G. Solutions Committee Recommendation: *Care Management*

The Solutions Committee has concluded that a strong commitment to disease state and care management programs offers a realistic likelihood of enhancing positive outcomes for active employees, retirees, and dependents, while at the same time reducing the need for increasingly intrusive health care measures and reducing overall plan costs.

18. The Boards should consider retaining a health care consultant to assist the Boards in evaluating disease state and care management programs.

19. The Boards should consider directing the health care consultant to review the disease state and care management literature and report relevant developments to the Boards on an annual basis.

20. The Boards should consider having the health care consultant evaluate the current care management programs of the City's health plan providers.

H. Solutions Committee Recommendation: *Health Plan Design*

The Solutions Committee has concluded that a continuing commitment to evaluating the structure of the City's current health plans is important. Health plan design must focus upon long-term health care impacts, not on short-term financial considerations that may actually increase long-term costs.

21. The Boards should consider retaining a health care consultant to review the adequacy and efficacy of the plan designs in the City's current health plan offerings.

22. The Boards should recommend to the City the adoption of recommendation no. 32 of the Public Employee Post-Employment Benefits Commission:

    > Health plan sponsors should identify individuals who are Medicare-eligible and inform them of the need to enroll in Medicare in a timely manner. Employers should provide those individuals with information on penalties which result from delayed enrollment in Medicare.

23. The Boards should recommend to the City the adoption of recommendation no. 33 of the Public Employee Post-Employment Benefits Commission:

    > Employers should provide incentives to individuals to enroll in Medicare and possibly a Medicare supplement plan once they become eligible for Medicare.

24. The Boards should recommend that additional efforts be made to encourage enrollment in Medicare of Medicare-eligible retirees who have not yet enrolled.

25. The Boards should direct the retained health care consultant to evaluate the current co-pay structures in the City's health plan offerings to determine if they impact access to health care.

26. The Boards should have the retained health care consultant report on the experience of other agencies in adopting lower retiree health care benefits for new hires or in implementing multi-tier health care benefit structures.

27. The Boards should consider establishing a joint committee to amplify these recommendations for review by the Boards.

I. Solutions Committee Recommendation: *Communication*

28. The Boards should recommend to the City the adoption of recommendation no. 18 of the Public Employee Post-Employment Benefits Commission:

> Public employers should provide clear explanations to employees concerning current eligibility rules for retiree health care and the terms under which retiree health care is earned. Employers should also clearly explain to their employees the conditions under which health benefits for retirees are to be funded and paid. This information should be communicated at regular intervals throughout an employee's career and through plan documents and collective bargaining agreements.

29. The Boards should recommend to the City the adoption of recommendation no. 19 of the Public Employee Post-Employment Benefits Commission:

> Public employers should provide timely notification to both active and retired employees when proposing a change in retiree health care benefits. This notification should be provided in a time frame that reasonably allows affected employees and retirees to understand the impact of the benefit change, to review other options available to them, and to comment to the employer on the proposed changes.

The Solutions Committee considers this list of recommendations to constitute a significant beginning in addressing the challenge of retiree health care.

THE SOLUTIONS COMMITTEE'S DELIBERATIVE/CONSULTATIVE PROCESS

A. Establishment of the Solutions Committee

The Joint Board Committee on Solutions to Retiree Health Care was established by action of both Boards of Administration, as a result of the request by the Chair of the Police and Fire Board. Both Boards realized the importance of the issues surrounding retiree health care and of the need to devote in a focused manner the time, energy, and resources necessary to consider this complex set of interrelated issues. The Boards also concluded that they were well placed to assist in developing the types of information and perspective outlined by the City Manager in her memorandum to the Council, dated December 17, 2007.

The City Attorney's Office, in a memorandum dated November 16, 2007, confirmed that the Boards, by establishing the Solutions Committee, were acting within the scope of their fiduciary duties:

> Both of the retirement plans include provisions whereby the plan pays a portion of the premium for medical insurance coverage for eligible retirees and eligible survivors. In addition, both plans include provisions whereby the plan pays the entire cost of providing dental insurance coverage for eligible retirees and survivors.

> The fiduciary responsibilities of the Boards include holding trust assets to pay these benefits and discharging their duties for the purpose of providing these benefits and minimizing contributions needed to pay for the benefits. One of the factors driving increases in the contribution rates is the rising cost of medical and dental insurance coverage.
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> To address concerns about the escalating costs of providing health care coverage for current retirees and those employees who will retire in the future and to explore potential solutions, the Boards established the Joint Committee on Solutions to Retiree Health Care.
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> The establishment of the Joint Committee on Solutions to Retiree Health Care is within the fiduciary responsibilities of the Boards of Administration. The work plan established by the Joint Committee is designed to carry out the assignment given the Committee by the Boards. Thus the scope of the Committee's work is in furtherance of the fiduciary responsibility of the Boards.

B. Composition of the Solutions Committee

The Solutions Committee was composed of seven individuals: three members of the Police and Fire Board, Mark Skeen, Ken Heredia, and Bret Muncy; three members of the Federated Board, Bill Thomas, Tim Callahan, and Council member Pete Constant; and Human Resources Director Mark Danaj.

C. Mission of the Solutions Committee

The Solutions Committee adopted the following as its mission statement:

> To provide information regarding retiree health care, identify problems that may exist, identify options for solutions, and make recommendations to each Retirement Board on the issues of retiree health care.

D. Meetings of the Solutions Committee

The Solutions Committee held from October 2007 through April 2008 a total of 13 meetings. A variety of different issues and perspectives were considered. The Committee, at its meetings, availed itself of the experience of actuaries, Kaiser physicians, underwriters, and managers from both Kaiser and Blue Shield, representatives from credit rating agencies, representatives from major fixed income investment managers, and experienced health care consultants. The Committee also listened closely to comments from the stakeholders attending the meetings.

E. Outreach by the Solutions Committee

The Solutions Committee understood from its first meeting that, given the complexity and impact of the issues being considered, it was necessary to reach out to as many stakeholders as possible, including employee organizations, retiree associations, City administration, etc. The

Committee did so through direct invitation and by distributing Committee meeting summaries to keep individuals informed of Committee activities, Committee progress on issues, and of future Committee meeting dates.

SUMMARY OF FINDINGS OF THE SOLUTIONS COMMITTEE

The Solutions Committee has considered the materials and information provided to it and has determined that the following findings are salient and should guide further policy deliberations in this area.

1. The cost of health care, including retiree health care, is increasing.

2. Disclosure requirements of the Government Accounting Standards Board have focused attention on retiree health care.

3. The GASB 45 projections for retiree health care for San Jose are substantial.

4. The funded ratios for each system's retiree health care liability are not substantial.

5. From the credit rating perspective, it is not necessary to immediately reach full ARC funding.

6. From the credit rating perspective, the City of San Jose is well regarded.

7. From the bondholder perspective, the City of San Jose is well regarded.

8. San Jose is well ahead of other public entities in funding the ARC.

9. The Public Employee Post-Employment Benefits Committee recommends prefunding an entity's retiree health care obligation.

10. Ramping up to full ARC contributions over at least a five-year period is reasonable.

11. Priority must be given to evaluating, in the very near future, the various vehicles consistent with applicable laws and available to prefund retiree health care, including a separate health care trust.

12. Emphasizing wellness of actives and retirees offers the realistic prospect of reduced medical costs in the future and therefore a lower ARC.

13. Emphasizing disease state and care management offers the realistic prospect of reduced medical costs in the future and therefore a lower ARC.

14. Emphasizing new approaches to accessing health care information offers the realistic prospect of reduced medical costs in the future and therefore a lower ARC.

15. Long-term health care solutions may require up-front investment in wellness and care management programs and other innovative programs.
16. Successful efforts to encourage eligible individuals not enrolled in Medicare to so enroll, will reduce not only the component of health care premiums attributable to this group, but will transfer to Medicare the health care costs associated with this group.

17. Active employees and retirees possess vested rights under the San Jose Municipal Code with respect to retiree health care benefits.

18. The current structure of retiree health care benefits under the San Jose Municipal Code merits rethinking.

19. In evaluating plan design changes, it is important to ensure that options promising cost reduction or the mitigation of health care trend increases result not just in short-term financial benefit but also long-term savings.

EXPANDED DISCUSSION OF THE FINDINGS OF THE SOLUTIONS COMMITTEE

1. The Cost of Health Care, Including Retiree Health Care, is Increasing.

The Solutions Committee was impressed by the extent of information presently available that documents the amount of current expenditures on health care, including health care expenditures on retirees and their dependents, and the future projections of those expenditures. It is startling to note that the nation expends approximately $2.1 trillion annually on health care.

2. Disclosure Requirements of the Government Accounting Standards Board has Focused Attention on Retiree Health Care.

The Government Accounting Standards Board (GASB) is the organization within the accounting profession that determines the accounting standards which an external auditor is required to apply to the audits of public entities, including the audits of cities and of public retirement systems. GASB from time to time issues statements of practice. In 2004, GASB issued statement nos. 43 and 45. GASB statement no. 43 (GASB 43) applies to public retirement systems and requires them to disclose the present value of future retirement health care costs on their audited financial statements. GASB statement no. 45 (GASB 45) applies to public entities and requires them to make the same disclosure on their audited financial statements. GASB 45 does not require a public entity to fund the future retiree health care obligation; it merely requires that the liability for that obligation be disclosed on the entity's financial statements. To the extent that, in a given year, the public agency does not fund the full amount of the Actuarial Required Contribution (ARC), that difference between the ARC and the amount funded is to be recorded in the public agency's financial statements as a liability. For San Jose, the effective date for implementation of GASB 45 reporting requirements is fiscal year 2007-2008.

3. The GASB 45 Projections for Retiree Health Care for San Jose are Substantial.

The most significant challenge for the Solutions Committee and for those attending its meetings was to understand the language and structure of GASB 43 and 45.

The first task was to obtain an understanding of the amount of the liability that exists for retiree health care. This task turned out to be complex and to involve a range of answers. The most significant variable affecting the answer was the choice of an interest rate, i.e., the rate of return on the assets being accumulated to fund the future costs of retiree health care. The actuaries confirmed the appropriateness of using the interest rate assumption applicable to each plan, i.e., 8.0% or 8.25%, as the interest rate, provided that there was a commitment to fund the future liability for retiree health care; otherwise only the much lower interest rate of 5.6% could be properly employed.

The choice of interest rate matters. The Segal Company, the actuary for the Police and Fire Plan, estimated the liability as of June 30, 2006 to be $590 million if the liability is funded on the 8.0% basis and $813 million if the liability is funded on the 5.6% basis. Gabriel Roeder Smith, the actuary for the Federated System, estimated the liability to be $585 million if the liability is funded on the 8.25% basis and $839 million if it is funded on the 5.6% basis. A commitment to fully fund the ARC thus reduces the combined unfunded actuarial liabilities by approximately $480 million or 29%. John Bartel & Associates, the actuary retained by the City, estimated the combined liability of retiree health care for the City to be approximately $1.65 billion. The three actuaries were not in total agreement on assumptions and methodologies and therefore their estimates differ. In actuarial terms, these amounts constituted the unfunded actuarial accrued liability or UAAL for retiree health care.

The next task was to focus on funding this liability. The relevant term in this context is the annual required contribution (ARC). The ARC, as described in GASB 45, is the sum of the City's normal cost for retiree health care and the amortized portion of the UAAL, with an open amortization period of thirty years.

For the Committee, the GASB 43 and 45 liabilities for retiree health care is a substantial number, with a corresponding task to consider the ARC, how to control it, how to pay it, and to what extent to pay for it.

4. The Funded Ratios for Each System's Retiree Health Care Liability is not Substantial.

The term "funded ratio" in the language of actuaries is the ratio that compares actuarial assets to actuarial liabilities. It is expressed as a percentage and is a commonly used measure of the actuarial soundness of a retirement system. Unlike the retirement benefits for each system, which are well funded, the funded status of the retiree health care benefits administered by each retirement board is not well funded. For the Police and Fire Plan, the actuary estimated the funded ratio for retiree health care as of June 30, 2006 to be 5%. For the Federated System, the actuary estimated the funded ratio for retiree health care as of June 30, 2006 to be 18%. These percentages are far less than the funded ratios for each retirement system as a whole, i.e., 99.7% as of June 30, 2007 for the Police and Fire Plan and 82.8% as of June 30, 2007 for the Federated System.

5. From the Credit Rating Agency Perspective, it is not Necessary to Immediately Reach Full ARC Funding.

The members of the Solutions Committee began this process with the same perspective that probably many others still share. That perspective was that the City's liability for retiree health care was large, the annual contributions needed to fund it were large, not funding it would generate a new and significant City liability to be included on the City's financial statements, and that the result might be a down grade in the City's credit ratings.

The Committee, on February 20, 2008 and on March 19, 2008, received presentations from Standard & Poor's, one of the preeminent, national credit rating agencies. The presentations by the Standard & Poor's representatives to the Committee mirrored the analysis set forth on Standard & Poor's website:

> We believe that, with or without the prefunding of OPEB liabilities, most employers will be able to continue to meet their ongoing OPEB cost requirements without an adverse effect on credit quality. OPEB costs will be worked into budgets and will need to be addressed, along with other normal costs of providing services. In that sense, any increase in costs for governments or governmental entities serves to pressure operations and potentially crowd out other spending. However, we anticipate that most entities will successfully manage these increased costs. OPEB liabilities are just one of many factors evaluated by Standard & Poor's, and the overall effect of the liabilities will be realized over a long period. How the liability is managed, along with a government's capacity to fund these obligations on an annual basis—either on a pay-as-you-go or an accrual basis—will be an important element of the credit review.
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> We've traditionally viewed unfunded postretirement liabilities as debt-like in nature because they represent future payments that usually have some legal basis for funding—whether constitutional, statutory, or contract-based. However, a postretirement liability is subject to significant variation based on the actuarial methods and assumptions used to calculate the liability as well as the performance of any fund assets. There is no consistent funding method or set assumptions for government pension accounting, which makes the liability difficult to compare across entities. This is an important differentiation from debt, where the obligation is fixed and the annual costs to service the debt are fixed.
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> The absolute OPEB liabilities reported may be large in many cases, but will not be considered the same as debt due to the variable nature of calculating the liabilities. The aggregate OPEB liability will not be totally comparable between governments, though we will attempt to make peer comparisons in terms of how entities manage this liability.
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> As previously mentioned, OPEBs have been part of the cost structure of governments for many years, and GASB 45 does not change that or the annual funding level. We will review the annual costs of funding pension and OPEB liabilities as part of our financial review. The effect of the OPEB liability on the income statement and balance sheet will be analyzed—especially as trend

> information becomes available. The annual costs to address these liabilities, along with annual debt service costs, will be a significant part of the financial review. It will also be important to analyze what the aggregate OPEB expense is relative to the size of the budget and the revenue base that supports the budget: this is analogous to a fixed-charge ratio. The annual expenses and total liability relative to the budget will be evaluated in the context of all of the other funding requirements or budget challenges faced annually by a unit of government.

In other words, the credit rating agencies understand that it is not necessary to reach full ARC funding within a short time period. Instead, what is necessary is a deliberative process ending in a well-conceived and practical funding plan. The Committee considers this position by the credit rating agencies to be an important contextual fact for San Jose decision-making in this area.

This finding is also consistent with the original staff memorandum to Council on this topic, dated August 7, 2007, which stated:

> Although GASB 45 does not mandate the pre-funding of OPEB liabilities, the ongoing failure to pre-fund these benefits may have a detrimental impact on an agency's long-term financial health and may adversely impact the agency's credit rating. Public entities, including the City of San Jose, must calculate the liability, decide whether and how to fund the liability, and make decisions about current and future benefits.

6. From the Credit Rating Agency Perspective, the City of San Jose is Well Regarded.

The representatives from Standard & Poor's spoke highly of the City of San Jose. With respect to its general obligation bonds, the City possesses a credit rating of AA+, only one increment below the highest possible rating and the highest rating awarded to a California public jurisdiction. One of Standard & Poor's four rating criteria is the quality of management, with its highest ranking being "strong." San Jose's management receives that ranking. In other words, the City of San Jose is the highest-rated city in California with a population greater than 250,000.

As Standard & Poor's states on its website with respect to the City's most recent general obligation bond offering:

> Standard & Poor's Ratings Services assigned its 'AA+' rating to San Jose, Calif.'s $93.5 million series 2007 GO bonds and affirmed the 'AA+' rating and underlying rating (SPUR) on the city's existing GO dept. The rating reflects:
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> - A broad and diverse area economy that is anchored by a strong technology presence;
> - Above-average wealth and income levels, coupled with strong competitiveness and education levels for city residents;
> - Solid unreserved fund balances exceeding 30% of expenditures, despite recent budgeted and actuarial shortfalls between revenues and expenditures; and
> - Moderate debt levels and manageable capital plans, including a currently well-funded retirement pension position.

7. From the Bondholder Perspective, the City of San Jose is Well Regarded.

The Committee, on February 20, 2008, received a presentation by Ron Price, a fixed income portfolio manager with Western Asset Management, one of the largest bond traders and fixed income managers in the county. Mr. Price stated that, although the markets were still digesting the news on retiree health care liabilities, the key point from the perspective of bondholders was whether the public agency possessed a credible plan to address the retiree health care liability. Immediate funding of the ARC was not necessary; reasonable progress to full funding was what would be measured. He added that San Jose debt instruments were considered sound investments.

The Committee drew the following conclusions from the presentations by Standard & Poor's and by Western Asset Management: that the initial perspectives of some Committee members were exaggerated, that full funding of the ARC is not required by the marketplace in the near future, and that the City should adopt a reasonable plan that aims at full funding of the ARC over a reasonable period of time.

8. San Jose is Well Ahead of Other Public Entities in Funding the ARC.

The Solutions Committee notes with pride that San Jose is far ahead of most other public employers in prefunding retiree health care benefits. As of June 30, 2007, the Federated System had \$96,601,000 reserved for future costs of retiree health care. As of June 30, 2007, the Police and Fire Plan had \$50,866,000 reserved for future costs of retiree health care. The Public Employee Post-Employment Benefits Commission found that 78% of California public agencies had not begun to fund any portion of their retiree health care liability. The same foresight and perseverance that had so far characterized San Jose's efforts in this area will continue to make it a leader in the future.

9. The Public Employee Post-Employment Benefits Committee Recommends Prefunding an Entity's Retiree Health Care Obligation.

The Solutions Committee, on the basis of its own deliberations, has arrived at the same conclusions concerning prefunding of retiree health care benefits as did the Public Employee Post-Employment Benefits Commission. The Committee concluded that the Commission's first and second recommendations are also applicable to San Jose:

> Public agencies providing OPEB [other post-employment benefits] benefits should adopt prefunding as their policy. As a policy, prefunding OPEB benefits is just as important as prefunding pensions. The ultimate goal of a prefunding policy should be to achieve full funding.
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> …
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> Each public employer shall identify its OPEB liability, adopt a prefunding plan, and make it public. If a public employer does not establish a prefunding plan, it shall

clearly identify an alternative approach for addressing its OPEB liabilities and make public its reason for not prefunding.

A commitment to fully funding the ARC allows the use of a higher interest rate, thereby reducing the plans' combined unfunded actuarial liability by almost 30%.

10. Ramping up to Full ARC Contributions Over at Least a Five-Year Period is Reasonable.

The Solutions Committee is convinced that an orderly approach to full ARC funding is the appropriate approach. The Solutions Committee is also convinced that a ramp-up to full funding over a time period less than five years is not reasonable. Five years or a period longer than five years appears to be reasonable and prudent.

a. Current Contribution Rates for Retiree Health Care

For the Federated System, the current contribution rate for retiree health care for the City is 3.82% of payroll and 3.32% of pensionable compensation for employees.

For the Police and Fire Plan, the current contribution rate for retiree health care for the City is 4.19% of payroll and 3.78% of pensionable compensation for employees.

b. Five-Year Phase-in Rates for the Federated System

Ms. Leslie Thompson of Gabriel Roeder Smith, the actuary for the Federated System, presented to the Committee the following five-year phase-in of employee and City contribution rates for the Federated System to reach the full annual required contribution (ARC) needed to fund on an actuarial basis the retiree healthcare benefits set forth in the Municipal Code:

		CITY			
Fiscal Year	**Employees**	**Cash**	**Implicit Subsidy**	**Total**	**TOTAL**
	(1)	(2)	(3)	(2)+(3)	(1)+(2)+(3)
2008-2009	4.65%	4.62%	0.63%	5.25%	9.90%
2009-2010	4.97%	4.91%	0.66%	5.57%	10.54%
2010-2011	5.28%	5.19%	0.68%	5.87%	11.15%
2011-2012	5.58%	5.46%	0.70%	6.16%	11.74%
2012-2013	5.86%	5.72%	0.71%	6.43%	12.29%
2013-2014	6.10%	6.00%	0.72%	6.72%	12.82%

c. Five-Year Phase-in Rates for the Police and Fire Plan

Mr. Andrew Yeung of The Segal Company, the actuary for the Police and Fire Plan, presented to the Committee the following five-year phase-in of employee and City contribution rates for the Police and Fire Plan to reach the full annual required contribution (ARC) needed to fund on an actuarial basis the retiree healthcare benefits set forth in the Municipal Code:

		CITY			
Fiscal Year	Employees	Cash	Implicit Subsidy	Total	TOTAL
	(1)	(2)	(3)	(2)+(3)	(1)+(2)+(3)
2008-2009	3.61%	3.94%	3.98%	7.92%	11.53%
2009-2010	4.77%	5.29%	4.12%	9.41%	14.18%
2010-2011	5.92%	6.56%	4.38%	10.94%	16.86%
2011-2012	7.08%	7.85%	4.48%	12.33%	19.41%
2012-2013	8.19%	9.08%	4.56%	13.64%	21.83%
2013-2014	9.26%	10.26%	4.60%	14.86%	24.12%

The Committee noted that the difference in rates between the Federated System and the Police and Fire Plan are due to the Federated System's current rolling 15 year funding period (as opposed to Police and Fire Plan's rolling 10 year period), the earlier average retirement age in the Police and Fire Plan (and therefore a higher number of years as a retiree prior to Medicare eligibility), and a higher percentage of Police and Fire retirees qualifying for medical benefits than is the case with Federated retirees.

The Committee was informed that cash rates had been reduced by the so-called implicit rate subsidy. The implicit rate subsidy is the amount by which the contribution rate paid by retirees as part of a composite rate with active employees is lower than the rate retirees would pay if they were insured by themselves. Ms. Thompson indicated that she had consulted with Carl Johnson, a research director at the Government Accounting Standards Board, who had approved this methodology.

11. Priority Must be Given to Evaluating in the Very Near Future the Various Vehicles Consistent with Applicable Laws and Available to Prefund Retiree Health Care, Including a Separate Health Care Trust.

The Solutions Committee surveyed in a summary fashion some of the vehicles available for prefunding retiree health care benefits. The Committee recognized that the restrictions in section 401(h) of the Internal Revenue Code on the amount of funding that may be made to a retirement system for retiree health care benefits must be taken into account when considering prefunding options. The Committee reviewed the CalPERS prefunding vehicle but noted that some of CalPERS's actuarial assumptions may result in contribution rates higher than may be necessary. The Committee concluded that a voluntary employee beneficiary association (VEBA) or an Internal Revenue Code section 115 trust may be better options for San Jose. Given that the section 401(h) limits may be reached in fiscal year 2008-2009, the evaluation process for a prefunding vehicle should begin as soon as possible.

12. Emphasizing Wellness of Actives and Retirees Offers the Realistic Prospect of Reduced Medical Costs in the Future and Therefore a Lower ARC.

The Solutions Committee received thorough and convincing information from The Segal Company and from Kaiser representatives about the emerging field of wellness. As conveyed to the Committee, wellness programs aim at persuading individuals to more energetically pursue the steps that lead to better health. The steps are familiar. They include more exercise, better diet, cessation of smoking, etc. What is unfamiliar is creating an employment-based consensus to adopt coherent wellness programs and vigorously implement them. The Committee acknowledges that this may be a multi-decade commitment. But a start needs to be made now.

It has been reported to the Committee that comprehensive efforts along these lines have already begun to be implemented by employers and by boards of trustees of private sector, union-management, Taft-Hartley health and welfare trusts. Implementing such efforts offers the realistic prospect of enhanced workplace productivity through increased attendance and reduced absenteeism. An important first step in this process is the recognition we are all active partners in the enterprise of health care and not merely passive consumers of health care services.

13. Emphasizing Disease State and Care Management Offers the Realistic Prospect of Reduced Medical Costs in the Future and Therefore a Lower ARC.

The Solutions Committee received thorough and convincing information from The Segal Company, from Kaiser representatives, and from Blue Shield representatives concerning disease state and care management programs. Most retiree medical costs are driven by a relatively small percentage of the retiree population. As conveyed to the Committee, care management programs at their best devote resources to individuals in various disease states to assist them in obtaining state-of-the-art treatment recommendations and to assist them in implementing those recommendations. A key goal of a disease management program is to stabilize a chronic condition and to defer, for as long as possible, deterioration in the disease state. There are many approaches being tried now. It is important to monitor the growing literature concerning successful care management programs. What seems clear, even at this stage, is that these programs are of value to individuals with serious, chronic conditions. Some San Jose retirees possess these conditions. Effective, well-funded disease state and care management programs would be of significant value to those retirees, while at the same time offering the prospect of a reduction in future health care expenditures for those individuals.

14. Emphasizing New Approaches to Accessing Health Care Information Offers the Realistic Prospect of Reduced Medical Costs in the Future and Therefore a Lower ARC.

The Solutions Committee is aware of the impressive steps being taken to apply advanced computer-based technologies to sort through the vast amount of available health care databases for the purpose of providing to patients and their families health care information of a high quality that is otherwise unavailable to them. Taking advantages of these developments and encouraging active employees, retirees, and their families to use these emerging resources offers the realistic possibility of increasing positive health outcomes and deferring or minimizing negative health outcomes.

15. Active Employees and Retirees Possess Vested Rights Under the San Jose Municipal Code With Respect to Retiree Health Care Benefits.

The primary focus of the Solutions Committee has not been upon the legal issues surrounding the structure of retiree health care benefits as set forth in the San Jose Municipal Code. The Committee has instead focused on the concrete, practical issues concerning funding of retiree health care benefits and concerning developing trends in the health care industry that may enhance retiree health and thereby reduce future retiree health costs.

It is nonetheless relevant to summarize developments in one immediately applicable area of the law. This area involves vested rights. Generally speaking, California courts have for decades made it clear that a public employee possesses vested rights in the retirement benefits in effect at the time of hire. The application of the vested rights doctrine to retiree health care benefits, however, has not been as thoroughly reviewed by the courts.

The Solutions Committee is pleased to note the proactive efforts of the City Manager with respect to this important issue. In a memorandum to all City employees and retirees, dated March 4, 2008, the City Manager stated:

> In addition, the City Council requested additional information regarding the legal issues related to changing retiree healthcare benefits. In San Jose, retiree healthcare benefits are in the Municipal Code as part of the City's retirement plans. Because San Jose retiree healthcare benefits are part of the City's retirement plans, the retiree healthcare benefit can be considered a "vested" benefit similar to the pension benefit itself. Based on this, we will not be recommending changes to retiree healthcare benefits (as specified in the Municipal Code) for current employees or current retirees at this time.
>
> Although this information may help address the existing concerns about the possibility that the level of benefit (100% of the lowest cost plan for single or family coverage) would be changed for current employees and/or current retirees, there remains a very significant challenge in funding the benefit. The unfunded liability is currently between $1.2 and $1.65 billion, and we will continue to face the challenge of paying the long-term costs of providing these retiree healthcare benefits. The City and employees covered by the current benefit share an interest in addressing the costs of retiree healthcare benefits for many reasons, including that the Municipal Code specifies that the costs are shared between the City and employees.

The Solutions Committee is equally appreciative of the Council's decision to release the legal opinion on this topic it had requested from the Los Angeles law firm of Jones Day. The 46 page legal opinion cannot be summarized in this report. But its overall conclusion can be set forth:

> As you know, both the United States and the California Constitutions prohibit the impairment of contractual obligations. Although the terms and conditions of public employment generally are controlled by statute or ordinance rather than by contract, the right to compensation already earned – particularly in the form of a pension – has been held to be vested and therefore protected under these constitutional provisions. A public employee's vested contractual right to pension benefits

> *accrues upon acceptance of employment*. By entering public service an employee obtains a vested contractual right to earn a pension on terms substantially equivalent to those then offered by the employer and to earn additional pension benefits pursuant to improved terms conferred during continued employment. The vested contractual right that accrues upon acceptance of employment includes promised survivor benefits.
>
> Vested pension rights have been held to include, not only the benefits payable at retirement, but the scope of a member's contribution obligation as defined under the terms of the contract. In addition, courts have extended the application of the vested rights doctrine to benefits, other than traditional service pensions, that have served as an inducement for continued service to the employer. Based on these authorities, a court likely would conclude that the constitutional protection applicable to traditional pension rights would also be applicable to the Federated and P&F Retiree Health Plans.

The Solutions Committee concurs with this conclusion and expresses its appreciation to the parties for providing clarity on this important threshold issue.

16. The Current Structure of Retiree Health Care Benefits Under the San Jose Municipal Code Merits Rethinking.

While the Solutions Committee acknowledges that the discussion of vested rights may have ended, there remains a very real issue concerning the structure and nature of retiree health care benefits themselves. The Committee is aware of the differences in interpretation of the relevant Municipal Code provisions advanced by the City Attorney's Office and by the Boards' outside counsel, Saltzman & Johnson. It is not part of the Committee's mission to resolve this legal dispute. The Committee, however, does believe it is imperative for this dispute to be resolved. The Committee is of the further opinion that resolving this dispute should be placed within a larger context. All of the stakeholders are now aware that decisions on health care options for active employees made by the bargaining parties may have a very strong effect upon retirees, an effect that may not only be substantial but may be one imposed without substantial advance notice.

The Committee recommends that the current structure which links retiree medical benefits to the medical benefits for active employees should be reviewed by the City and the bargaining units. Both bargaining parties and retirees may desire greater flexibility to consider an increased range of health plan options than the current structure provides. It is clear that retirees desire greater certainty in their health care benefits.

CONCLUSION

The Solutions Committee has completed a comprehensive process of considering the nature of the City of San Jose's retiree health care liability and has adopted a set of recommendations which are positive, proactive, capable of being realized, and which offer better health outcomes to employees and to retirees. The Committee respectfully requests that the Boards of Administration consider the Committee's recommendations and adopt them as their own.